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Commercial Bank Provisioning Against Claims on Developing Countries

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Commercial banks, through their provisioning, recognize that they expect less than full payment on their developing country debt. Provisioning reduces the willingness of banks to provide new funds, increasing the importance of debt-reduction schemes. Banks would like the multilateral agencies to take the lead. One answer, now or in the future, may be an international bankruptcy court.

With Mexico's announcement in 1982 that it could not meet its debt obligation, the debt crisis — which arose from the spate of lending that began with the 1973 oil hike — became public. In 1985, Peru limited payment on its debt obligations. The 1985 Baker Plan — designed to lend more to heavily indebted countries in return for structural adjustment within them — had little impact on financial flows. In 1987, Brazil suspended interest rate payments on part of its debt.

Against this background, Citicorp decided in May 1987 to add $3 billion to its loan loss reserves — and many other money center banks, in the United States and abroad, followed suit. Such provisioning — putting aside reserves in low-earning but risk-free assets to cover the possibility of default on loans — reduces both risk exposure and short-term earnings.

No matter what the banks say otherwise, one implication of provisioning is that the banks expect less than full repayment of these debts. Banks with large provisions will lean more toward debt relief than toward the injection of new money to debtor nations. The alternative to debt relief may be general default — given the deteriorating economies in debtor countries, the gloomy global outlook, and the diminished expectation of new monies.

Provisioning may be seen as the commercial banks' first step toward extricating themselves from a certain kind of investment in developing countries. A general feeling in the banking community is that the multilateral agencies must take a stronger role than they have in resolving the debt problem — not that they lend vast sums of money but that they assume stewardship of the debt crisis, adopting a clearly thought out strategy, and making more constructive use of conditionality.

One proposed instrument for this is an international bankruptcy court (the International Debt Restructuring Agency). It would bring together creditors, the debtor country, and the multilateral agencies to work out an appropriate debt relief agreement, conditional on adjustment measures undertaken by the debtor country.

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by
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SUMMARY AND CONCLUSIONS

There is considerable confusion over what commercial bank provisioning is and over the extent to which it has been practised. Section I of this paper provides some clarification of these issues, although the data are far from comprehensive. The important technical distinction between provisioning and writing down is explained, although, by its very nature, provisioning must suggest some presumption that writing down will to some extent become necessary. The data reveal that cross-sectionally there have been significant differences in the practices as regards provisioning against their claims on developing countries by banks in different creditor countries. Moreover, through time there have been changes in the extent to which banks have provisioned. There was a notorious surge in provisioning during the summer of 1987 led by Citibank's decision in May to add to its loan loss reserves. Section I also catalogs the extent to which national environments are provisioning-friendly.

Section II of the report goes on to examine in more detail some of the factors which influence banks' provisioning decisions. In part these help to explain both the cross-sectional and time series differences mentioned above. A distinction is drawn between secular changes which contributed to the perceived need for greater provisions, and more proximate bank specific factors. The deteriorating economic performance and prospects of many debtor nationals created an environment in which provisioning became increasingly appropriate. Yet, it was the reflection of this in the market valuation of

the banks which put direct pressure on them to set aside larger reserves. Moreover, banks seemed anxious to create greater flexibility for manoeuvre in their balance sheets and provisioning had the effect of doing this. At the same time there is considerable doubt as to whether most banks would have added to their provisions had it not been for the Citibank move. This reflects the element of competition involved in the provisioning episode. Some of the factors relevant to explaining cross-sectional differences across countries, such as the tax and regulatory environment, do not seem to have had an important influence on changes in provisions through time, although there may be scope for using the tax system to encourage banks to offer debtors some greater degree of relief.

Section III explores the ramifications of provisioning for banks, debtor countries, and the official sector. Again these do not appear to be of fundamental importance in terms of resolving the international debt problem. The banks are provided with greater opportunity to pursue debt sales and debt equity swaps, but provisioning has little direct effect on debtor countries. Of course any policy change alters the negotiating environment, but even here there is considerable ambiguity about what effects extra bank provisioning has and some confusion about whose bargaining position is strengthened. There is more consensus that, for various reasons, provisioning will reduce the size of future bank loans to developing countries. This may be of limited significance inasmuch as the loans were likely to be small in any case, but, if not replaced from other sources, such a reduction could increase pressures on debtor countries to default on their debt. Through this prospect, provisioning puts pressure on the official sector to do more in helping to resolve the international debt problem.

Section IV examines various ways in which an international debt strategy, under the auspieces of the multilateral agencies, might evolve following the provisioning era. It is argued that many of the issues raised by provisioning could be addressed by establishing an initiative to bring together all the parties involved and to agree on a structured program of selective debt relief combined with enhanced policy conditionality. 1/

The overall conclusion is therefore that, while provisioning hardly represents a solution to the debt problem on its own, it may represent one step on the road towards such a solution. If, however, the impetus for reform which may have been given by the banks' actions is not followed through there is a risk that provisioning may actually worsen the debt problem by raising the likelihood of debtor default.

INTRODUCTION

Although this report focuses on "provisioning" by commercial banks against their loans in developing countries, it is important to put this development into the general perspective of the evolving international debt problem.

As is well cataloged in the literature, the seeds of this problem were, in many ways, sown following the first major hike in oil prices in 1973. Developing countries facing large balances of payments deficits were attracted to the alternative of financing which enabled them to adopt a slower speed of adjustment than would otherwise have been necessary. Even some oil-

1. The significance of conditionality should be underlined. Resolution of the global debt problem depends crucially on the pursuit of appropriate policies in the debtor countries themselves.

rich countries were encouraged to borrow on the strength of their oil resources. The required financing was, in large measure, provided through the intermediation of the private international banks with the official sector adopting a relatively muted role. 2/

By 1982, however, there were very visible signs that this spate of lending had problems associated with it. Mexico announced that it would be unable to meet its debt obligations and the debt "crisis" became a matter of wide public debate and concern. A series of potential reforms were put forward by various commentators, but, in practical terms, the crisis has been largely managed by a combination of adjustment in the debtor countries, rescheduling, and new loans implicitly capitalizing a portion of scheduled interest payments.

Initially, there were some indications that this policy approach, applied in a flexible fashion, would prove adequate and there were even press reports in late 1984 and early 1985 suggesting that the crisis was over. However, such optimism was short-lived and, in retrospect, depended crucially on the ability of the United States to sustain the rapid economic growth it had achieved during 1984. By the mid-1980s there were many signs that the global debt problem was in fact getting worse rather than better, and some signs that the debtor countries might begin to adopt a somewhat more aggressive posture in their negotiations with creditors. In July 1985, for example, Peru's government announced that it would limit its payments of

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2. The official sector did respond in some ways. For example, the IMF established an Oil Facility to assist those countries particularly adversely affected by the oil price rise.

principal and interest to a maximum of 10 percent of the country's export earnings.

Towards the end of 1985 the United States endeavored to seize some of the initiative by putting forward a set of proposals, the Baker Plan, designed to encourage more lending to heavily indebted developing countries in return for structural adjustment within them. In practice the Plan had very little discernible impact on the quantity of financial flows. With much of 1986 being dominated by eventually successful attempts by creditors to negotiate an acceptable package of policies with Mexico, under the auspices of the IMF, February 1987 saw Brazil suspending interest rate payments on part of its international debt.

It was against this background that Citicorp decided to add $3 billion to its loan loss reserves in May 1987, a move which was fairly quickly matched by other money center banks in the United States and by many International banks elsewhere.

The purpose of this report is to examine both statistically and analytically various aspects of commercial bank provisioning. The report is divided into four principal parts. The first examines the nature and extent of provisioning, drawing out the differences that exist between countries and explaining the implications of provisioning for banks' balance sheets. The second looks at the various factors affecting the decision to provision and tries to differentiate between those of a long term and secular type and those of more short term and proximate relevance. The third examines the implications of provisioning for both creditors and debtors and for the global debt situation in general. The fourth and final section wanders a little beyond the central question of provisioning to review more broadly certain options which might be considered in attempting to alleviate the problem of global debt. 3/

I. FACTUAL AND STATISTICAL BACKGROUND

Although the phrases are sometimes used interchangeably there is an important distinction between writing off, writing down and provisioning against loans. In the case of writing off or writing down a loan, the creditor institution reduces the book value of the asset in its balance sheets, to a level which reflects its net present value more accurately. In general, banks have been reluctant to write down loans and have only done this against claims on a fairly narrow range of countries. Instead what they have done is to "provision" against certain loans by putting aside reserves in low earning but risk free assets in order to cover the possibility that repayments of principal or payments of interest might not be made. Extra provisioning therefore is the same thing as building up loan loss reserves.

These reserves may be "general" or "specific". The former represent the normal business practice of allowing for the fact that there is a statistical probability that a certain proportion of loans will encounter problems. Specific provisions are, however, set aside against loans to a particular country or group of countries where a specific risk has been identified. 4/ Apart from anything else, the distinction between general and specific provisions is significant since tax deductions are not allowed

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3. For a broader review of the evolving International debt crisis see, for example, Graham Bird, World Finance and Adjustment; An Agenda for Reform, Macmillan, London, 1985, Chapter 8.

4. Most provisioning that has been made by commercial banks has publicly been presented as being against a group of (say) 35 countries. The banks themselves, however, arrive at the overall provision by aggregating notional provisions against individual countries.

against general provisions (in the United States this has only been the case since 1986 when Federal Tax Law was changed), whereas creditors may be able to negotiate some tax reductions against specific provisions.

Because the setting aside of reserves reduces the provisioning institution's earnings, it has an adverse effect on profits. While the creditors' extent of risk exposure is reduced by provisioning, a price has to be paid in terms of reduced short term earnings. 5/

In attempting to provide some form of factual and statistical background against which the causes and effects of provisioning may be assessed in subsequent sections, this section examines the following questions. First, to what extent has provisioning or reserving by the banks occurred, and does it vary between banks across countries and over time? Second, do tax and regulatory environments differ in terms of their treatment of provisioning and third, to what extent does the bank provisioning that has occurred reflect the discount on developing country debt observed in the secondary market, and has provisioning been adequate?

A major difficulty in providing comprehensive answers to these questions is the lack of data concerning provisioning against developing country loans, the confidentiality with which much of the data that are available are treated, and the general degree of opaqueness in some countries relating to issues such as the position and attitudes of the regulators and the tax authorities.

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5. Provisioning decisions therefore reflect the conventional choice that has to be made between return and risk.

Most of the data in this report are drawn from the International Bank Credit Analysis Group (IBCA) sources, although even here, the data is constrained by the factors just listed. 6/

Table 1 shows the exposure of the banks, by country of origin, to individual Latin American states. Clearly the degree of exposure in these highly indebted countries is likely to influence the banks' attitudes to provisioning. Table 1 reveals the dominant position of the US banks. Exposures are, however, also significant in the cases of the UK and Japanese banks, becoming less significant in the case of banks in France, Germany and Canada, and much less significant in the case of those in Switzerland and Italy. (Exposure relative to capital would be a better measure but cross-country comparisons of bank capital are difficult.) Given that the costs of provisioning will be positively related to the extent of exposure, it might be anticipated that banks in the countries where exposure is less would tend to favor rather higher percentage provisions (related to the values of their loans to individual or groups of developing countries) than would banks in countries where exposure is greater. In the latter group of countries the absolute costs of provisioning will be higher. This, in turn, suggests that the extent of provisioning will be more affected by the ability of the banks to make such provisions, than by an unbiased assessment of risk. However it needs to be noted that U.S. Banks also hold a larger overall portfolio of loans, with the result that their relative exposure may not be high by international standards. For example, it is reported that at the end of 1986

6. The report, however, draws not only on published statistics but also on a range of interviews conducted with bankers and officials in London, New York and Washington.

the portfolio of U.S. Commercial Banks was twelve times as large as that of Canadian banks, but not their loans to Latin American countries were only five times larger.

Even so, my idea of a negative relationship between exposure and percentage provisions appears to be borne out by the data in Table 2 which shows the percentage reserves held against developing country loans in a number of countries at the end of 1986. However, the table also reveals that there has been significant differences between banks even within the same country. Furthermore, although many banks do not make available information concerning their reserving against individual countries, what information is available suggests that there may be quite wide divergences. Thus, for a bank with an overall provision of (say) 25 percent, the reserve against one Latin American country may be as low as 5 percent, while that against another may be as high as 35 percent. 7/

To some extent the different pattern of behavior with regard to provisioning may reflect the traditionally different attitudes of bankers throughout the world to the optimum point on any return/risk trade off. Germany bankers are, for example, not infrequently critical of the rapid expansion of loans to developing countries by US banks during the 1970s precisely because of the risks it involved, and their more prudent approach to lending (not revealed, of course, in German bank lending to Eastern Europe in the 1970s).

Beyond this, however, is the question of how important are

7. These figures are derived from the practices of Dutch banks in 1986 as reported to IBCA Banking Analysis.

differences in the tax and regulatory environment in explaining international differences in provisioning. Would a US bank faced with the German environment have provisioned more, and would a Germany bank faced with the US environment have provisioned less?

In order to offer some answers to this question we need to identify what differences there are in the regulatory and tax environments across countries.

In the US most large banks are regulated by the Federal Reserve Board (FED) or the Office of the Comptroller of the Currency. Because of its insurance role the Federal Deposit Insurance Corporation (FDIC) also has a hand in determining provisioning regulations, as well as rules relating to capital adequacy. The regulators' attitudes to provisioning are coordinated through the Inter-Agency Country Exposure Review Committee (ICERC). It is this agency which sets standards for how banks should treat loans to countries that are not servicing their debts.

Under existing regulations US banks must hold reserves equal to at least 5.5 percent of total assets and capital equal to at least 6.0 percent of total assets. Beyond establishing these ratios there are no further regulations relating to general provisions. The regulatory bodies may, however, require banks to make specific provisions against individual countries in the form of allocated transfer risk reserves (ATRR). In the first year following such a requirement the ATRR has to cover a minimum of 10 percent of the loans, rising by 15 percent in subsequent years. Such reserves are tax deductible but they have been rarely used in the past. [8]

While US banks can no longer claim any proportion of general provisions against tax, such provisions do count as part of the banks' capital base and therefore do not damage the banks' position as far as the regulations relating to capital adequacy are concerned. Furthermore, US banks can claim tax allowance for actual "write downs" against provisions. More broadly, it is through this tax mechanism that regulators may, in principle, encourage banks to offer some form of debt relief to debtor countries. [9]

In Germany the tax laws are particularly favorable to provisioning and permit reserves to be deducted from taxable profits. Furthermore, the financial authorities have actively encouraged German banks to be prudent in the valuation of their claims of developing countries. French regulations are slightly less liberal in as much as provisions against sovereign debt are only tax deductible if the debtor country concerned is on a list of 41 countries compiled by the country's Banking Commission. For such countries, provisions

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8. The ICERC may classify problem sovereign debts as sub-standard, value impaired or a loss. To be classified as value-impaired a debtor must fulfill more than one of four conditions: that it has not paid interest for six months; that it is failing to comply with an IMF supported program; that it has failed to meet its rescheduling terms for a year; and that there is little prospect for an orderly restoration of debt service in the near future.

9. Of course a write-down by a bank does not alleviate the debtors' contractual obligations, but, in principle, the tax system offers one way in which the burden of adjustment to the debt problem could be shared between the banks and the governments of creditor countries. Greater tax allowances could for instance be made for banks which translated a write-down into a reduction in the debt service payments of the debtor country.

are deductible from taxable profits up to 100 percent of the face value of the loan.

By contrast, in Japan, banks may not deduct more than 20 percent of their provisions from taxable profits. Moreover, regulations permit them to hold reserves against no more than 5 percent of their total loans. (Recently these regulations have been liberalized slightly.)

In the UK, regulators have encouraged the banks to consider the adequacy of their provisions with respect to their developing country loans without setting minimum or maximum values. Specific provisions do not count as capital and general provisions are not tax deductible. The tax status of specific provisions is unclear. There is certainly no presumption that these may be automatically offset against tax. Much would seem to depend on the particular negotiations between an individual bank and the tax district handling its affairs. [10]

The above review does seem to imply that the tax and regulatory environment has been more supportive of provisioning in countries where banks have conventionally held somewhat higher provisions. But it may be unwise to draw the conclusion that there is necessarily a strong causal link. Prior to the change in Federal Tax Law in 1986, for example, US regulations were perhaps rather more liberal than in the UK and yet US banks did not hold proportionately higher reserves. In this case the reluctance of US banks to

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10. IBCA reports the following ranges of provisioning (in percent of loans) permitted to UK banks by the Inland Revenue: Argentina, 5-10; Brazil, 5-10; Bolivia, 75; Chile, 5; Cuba, 5-25; Guyana, 25-30; Jamaica, 10-25; Liberia, 25-30; Mexico, 5-10; Nicaragua, 10-50; Nigeria, 10; North Korea, 80; Peru, 15-30; Philippines, 10; Poland, 25-30; Sudan, 30; Yugoslavia, 5-10; Zaire, 40-50; and Zambia, 30.

add to their reserves may have reflected their high absolute exposure reported in Table 1, but it does serve to show that the tax and regulatory environment may not be a dominant factor.

This is confirmed when changes in provisioning are observed through time. Concentrating again on the United States, the changes in the tax treatment of provisions in 1986 should, if anything, have made additional loan loss reserves less attractive. Yet it was in early 1987 that the principal increases in such reserves by the US money center banks were made. Early reports in the media that Citibank's decision was largely influenced by tax considerations appear to be entirely without foundation, as discussions with Citibank and the US Treasury confirm. Indeed meetings between Citibank and the Treasury were held after the bank's announcement of extra reserving to clarify the tax position largely because of the confusion caused by these press reports. Similarly, decisions to increase provisions by the UK clearing banks were made even though the tax treatment of these provisions was yet to be agreed.

The large increases in the provisions of the US and UK banks and their effects on bank balance sheets are shown in Tables 3, 4, 5 and 6. From Tables 3, 4 and 5 it may be seen that in the case of the US banks, the additional reserving raised their reserve-to-developing-country exposure ratio to something around an average of 25 percent; although, again there is significant variation amongst individual banks.

Table 5 shows, however, that provisioning generally increased the primary capital to assets ratio, but uniformly reduced the equity component of primary capital. Table 6 estimates the effects of differential tax relief on the UK banks, assuming that provisions are uniformly increased to 30 percent. It also shows the effects of provisioning on pre-tax profits. As far as these are concerned it may be seen that provisioning shifts two of the five banks from profit into loss. Not surprisingly these are the banks with the highest developing country exposures. Furthermore, for these banks in particular, the table shows how the amount of tax relief can make a significant difference to their equity position. For the relatively less exposed banks the importance of tax relief clearly becomes more muted.

Given the figures in Table 6, it is reasonably easy to form a retrospective prediction as to which banks amongst the UK clearers would be the more and less likely to set off a train of provisioning. Such a prediction might have been more difficult to formulate in the US case on the basis of the figures presented in Tables 3 and 4, though, as will be seen in later sections of this report, it is possible to offer an explanation as to why Citibank did take the lead, even though its balance sheet does not necessarily suggest that it was in the strongest position to do so.

Taking into account the recent additions to reserves, Table 7 estimates that the aggregation of provisions against loans to developing countries held by banks in the principal creditor countries is currently rather in excess of $70 billion.

In a sense such an estimation begs as many questions as it answers. One very important question it raises is whether current levels of provisioning are adequate. A related question is whether provisions will be increased in the future?

One way of approaching these questions is to compare actual provisioning with the market discount on developing country debt. Table 8 shows the market prices of a sample of such debt. This table reveals that, with the exclusion of Peru, the average discount on the debt of the other five Latin American debtors was nearly 35 percent in April 1987 and about 52.5 percent by March 1988. The table shows in the case of Peru how a strongly negative assessment of a country's debt policies will be reflected in the market value of its debt. It also shows, however, that the size of the discount will be influenced by factors which are external to the country concerned. Thus the discount on both Mexican and Venezuelan debt increased as oil prices fell.

The connection between the size of the discount on developing country debt and the amount of provisioning required is, to some extent, supported by admittedly sketchy information on individual country provisioning by the banks. In broad terms, discussions with bankers suggest that provisions are highest against those countries which have the greatest discount on their debt in the secondary market. However, the relationship is by no means perfect. In 1986, for example, some banks were setting aside significantly greater provisions against Brazilian debt than against Venezuelan debt, even though there was a marginally greater discount on Venezuelan debt in the secondary market. At the same time, provisions against Argentine debt were significantly greater than those against Chilean debt even though there was very little difference in the secondary value of their debt.

If one takes the market valuation of developing country debt as a reasonably accurate indicator of risk and of its net present value, it would appear most banks in some countries are still under-provisioned. However, it is not entirely clear whether the market valuation of debt is an accurate measure of the extent to which the banks should provision against it. First, there is the argument that the market is too thin and vulnerable to distortions to provide a balanced assessment of risk. Second, some bankers argue that the debt is worth more to them than its market value suggests because the banks have leverage with the debtor countries. Third, bankers have maintained that their superior position with respect to participation in debt equity swaps and the rate of return on such investments serves to raise the value of the debt to them as compared with the market valuation. 11/ Certainly leading bankers have argued that they do not expect to have to use the entire amount of their loan loss reserves. Moreover some commentators claim that the reluctance of the major banks to participate in a recent move to swap Mexican debt for banks, suggest that they value this debt above the secondary market price.

Legitimate doubt may be expressed over the above arguments. With the degree of current participation in the secondary market, there may be a reasonable presumption that it is relatively efficient, and that it provides as good a guide as anything to the net present value of developing country debt. 12/ Similarly it might be argued that the leverage on policy that the banks exert is actually activated via the intermediation of the IMF and the World Bank and that this will be incorporated within the market's valuation. Furthermore, the returns to equity investment are available to all participants in debt equity swaps and not just the banks, and it is perhaps

11. For this reason, Citibank have argued that the effective discount is no more than 20 percent, and not the higher level shown by the secondary market.

12. About 250 banks and 50 non-financial companies are reported to be trading in the market with a turnover in 1987 expected to be $10-15 billion. Salomon Brothers have argued that at this level of business market prices represent a more reliable consensus view than the subjective opinions of top banking executives which creditors currently accept.

doubtful as to whether the banks possess superior information on investment opportunities. Finally, when a reasonable estimate of the percent value for the principal is made, it becomes unclear as to whether the new Mexican banks clearly represented a superior asset over existing debt.

Taking secondary market valuations as the best guide to country risk that is at present available, what would be the implications for the banks of raising provisions to the levels that such valuations imply? On the basis of the information contained in Tables 7 and 8, additional provisions of about $70 billion might be appropriate, raising total global provision to about $140 billion. Additional provisions of this amount would clearly have significant implications for the balance sheets of the provisioning banks and might well be deemed to have unacceptable consequences for earnings, profits and capital adequacy. 13/

Having set the factual and statistical scene the next section goes on to examine in more detail the factors that may influence provisioning decisions by the banks.

II. FACTORS AFFECTING PROVISIONING

Without doubt there is a range of factors which, in some sense, impinge on the decision to set aside provisions. Some of these may be fairly

13. Phillips and Drew in their regular review of the UK clearing banks point out how difficult it is to make comparisons of provisions adequacy between banks. However, examination of the ratio between provisions and non-performing loans (NPLs) for the British banking industry as a whole shows that this has increased from 105 percent in 1981 to 124 percent in 1987, i.e. provisions have been rising relative to NPLs, showing a more conservative attitude amongst bank managements. Of course this does not necessarily mean that provisions are now adequate; it could simply reflect the extent of inadequacy in earlier years.

general, affecting most banks in a broadly similar way, others may be more specific to a group of banks - perhaps in a particular country, or indeed to one specific bank. The difficulty is not so much in thinking of a list of factors which might, in principle, influence provisioning but in classifying these in a coherent fashion and in assigning them relative weights. With regard to the latter problem, the quantity and quality of the data does not permit any sophisticated empirical investigations of the issues involved. Instead, the empiricism used here is of a fairly casual sort, with conclusions on the relative importance of different factors being drawn rather more from discussions with those people involved in the actual provisioning decisions.

The first sub-section below identifies a number of broad secular trends which created an environment within which provisioning was more likely to occur than formerly. The second sub-section then turns to examine some rather more micro, or bank-specific factors. The third sub-section endeavors to attach some approximate weights to these factors in the context of two specific case studies; Citibank's decision to add $3 billion to its loan loss reserves on May 19, 1987, and the related decisions by the other US money center banks, and National Westminster Bank's decision to add 466 million to its sovereign debt provisions on June 16, 1987 and, again, the related decisions by the other UK clearing banks.

Secular Factors

(a) Economic performance in debtor countries

Over the years, and particularly in the light of experience since 1982, commercial banks have come to reassess the economic performance of the highly indebted developing countries to which they have made loans in the past, and therefore to reassess also the risk attached to such loans. Banks, generally speaking, have become increasingly sensitive - some might even argue over-sensitive - to risk, having perhaps failed to pay sufficient attention to it and too much attention to nominal return during the earlier phases of lending. 14/

In essence provisioning reflects a reassessment of the risks associated with a given portfolio of loans. As perceived risks rise, so there will be a tendency for provisioning against these risks to rise as well.

Economic performance amongst the highly indebted countries is most unlikely to be perfectly positively correlated, even though, to a certain extent, all debtor countries will be similarly affected by some world economic developments such as rising interest rates and increasing protectionism. This lack of correlation will encourage banks to examine countries individually, to form views on their separate creditworthiness and on the extent to which they should provision against them. This is the case even though the banks usually publicly provision against a group of countries rather than individual countries. Given this case by case approach, it may be somewhat misguided to look at data for an aggregated group of countries. Yet, if this is done, plenty of evidence may be found to support the view that the underlying economic performance of the major debtor countries had been deteriorating over recent years. Although some debtor nations have achieved a notable strengthening in their current account balance of payments, this has frequently been achieved against a background of stagnating growth, and

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14. For a critical review of banks' approaches to country risk analysis, see Graham Bird, "New Approaches to Country Risk", Lloyds Bank Review, October 1986.

falling levels of trade. In many ways perhaps the most worrying sign has been the falling investment ratio in many highly indebted countries. [15] While banks may regard some measure of short-run domestic demand deflation as an appropriate component of economic adjustment, they also recognize that the ability of countries to service their debt hinges, in the long run, on sustained economic growth.

Given the central significance of investment in generating economic growth, falling investment ratios can do little other than cause concern to creditors about the long-run capacity of countries to cope with their debt.

At the same time as there are signs of deteriorating economic performance in the highly indebted countries, various debt indicators also suggest that the debt position is itself getting worse. The most frequently consulted ratios, such as the debt service ratio and the interest payments to exports ratio, show a significant deterioration. Moreover, the banks can hardly fail to acknowledge that the change from positive to negative net transfers bring closer the threat of default, as the benefits of debt repudiation rise relative to the costs.

Given the picture as painted above, provisioning may be viewed as an entirely appropriate recognition by the banks of what is, according to various criteria, a worsening situation. A discrete decision to provision might, of course, be associated with some stochastic shock which weakens both the economic and debt position of the highly indebted countries, or as a response

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15. Gross investment in the Baker Plan Group of 15 heavily indebted countries has fallen from 24 percent of GNP in 1982 to 17 percent in 1986. Falling import volumes may also suggest that fewer capital goods are being imported.

to a gradual and more prolonged weakening in their position. In as much as it is indeed the underlying economic strength of the debtor countries which is the fundamental determinant of provisioning, it might be anticipated that provisioning activity will vary through time as economic performance changes. A decision to set aside provisions of a certain amount at one moment in time does not therefore mean that these will necessarily be seen as appropriate in the future.

Since the economic performance of the debtor countries is a phenomenon which may be fairly objectively monitored and which is largely outside the control of the banks, it might initially be thought that all banks would tend to hold similar provisions. Further thought, however, reveals that this need not be the case. Different banks will have different exposures in different countries, may be more or less risk averse, and may interpret a given set of data differently. Their perceptions of risk may therefore vary. Moreover, as will be seen in the rest of this report, there are various other factors which influence provisioning, and difference amongst the banks in relation to these factors may account for differences in the extent of provisioning.

(b) World macroeconomic outlook

While the above discussion suggests that provisioning will be affected by the past and contemporaneous performance of the debtor countries, the banks are in fact taking past performance as an indicator of future performance; it is this, after all, that will affect the countries' ability to service their debts. The future economic performance of debtor countries will, of course, depend on the performance of the industrialized economies of the world. Various models and estimations have been made of the degree of interdependence between the developing world and the industrialized world, and opinions vary on its significance. Yet clearly a scenario of falling or stagnant rates of economic growth within the industrialized countries, rising rates of interest and increasing protection suggestion, in combination, that debtor countries will face difficulties in expanding their export earnings and in increasing debt service payments. In these circumstances the banks will again tend to increase the risk attached to a given portfolio of loans to developing countries and may be encouraged to increase their provisions against such loans. A pessimistic global economic outlook may make other bank assets also appear more risky, but perhaps developing country loans are particularly vulnerable to the economic variables listed above.

Since bankers' perceptions in the first half of 1987 were of a world economy with a slow rate of growth, a view based largely on projections from various International and quasi official agencies, it follows that their view of the riskiness of their loans to developing countries was likely to be adversely affected.

(c) Changing methods of risk assessment

There has been plenty written in the literature to suggest that the banks' techniques for assessing risk as used to appraise loans during the 1970s were not necessarily very scientific in nature, and there are some suggestions that since that time they have improved on their assessment methods. 16/ With loans being continually reassessed it might be expected

16. See Bird, ibid.

that the use of different techniques would result in different perceptions of risk.

Although this argument might, in principle, explain why developing country loans have gradually come to be regarded as more risky by the banks that made them, in practice the modifications in country risk analysis are probably not sufficiently important to constitute a major factor. What is true is that the more traditional methods of risk analysis would also be suggesting increased risk. Furthermore, as noted earlier, experiences since 1982 have simply made the banks more risk averse than they were before.

(d) Evolutionary stages in the debt crisis

Some commentators maintain that the debt crisis in the period since 1982 has gone through a series of stages. At different times emphasis has been placed on economic adjustment in the debtor countries, rescheduling of existing debt on more and less stringent terms, and the injection of new money. An approach encompassing these various components was built into the Baker Plan of 1985.

The hope has clearly been that these various policies would, in conjunction, solve, or at least effectively alleviate the debt problem. The hope has not, however, been realized. Indeed, in some instances, the banks have viewed the approach as becoming less successful as time has gone on. They certainly perceive a "weakening" in IMF conditionality in recent years. Provisioning may represent a response by the banks born out of frustration with the inability of the International economic system as a whole to resolve the debt problem. Rather than sustain the belief, or the impression, that the problem will be resolved within a reasonable time span, provisioning may be seen as an internal legitimation by the banks of the situation as it is. In a sense provisioning reflects the gradual change of mood amongst bankers from optimism, or at least guarded optimism, to pessimism with respect to the prospects for solving the International debt problem.

(e) Internal adjustment within the banks

Emphasis has usually been placed in the literature on the need for adjustment within debtor countries brought about by the acquisition of debt and its related obligations. While this need cannot be denied, developing country debt has also brought about a need for adjustment within the banks that have made the loans. Banks have indeed been engaged in this process of adjustment by strengthening their capital bases and by looking for new and more secure lines of business. Although some banks have pursued this process more successfully than others, the trend has been fairly general. Provisioning may reflect the fact that within this secular process of adjustment banks now feel sufficiently strong to stand the cost of provisioning.

Moreover, internal adjustment within the banks is unlikely to comprise only growth in other lines of business. The banks are without doubt anxious to remove some of their developing country loans from their books. However, this is difficult to do while the loans have full face value in the balance sheets of the banks and a discounted price in the secondary market. Provisioning, which essentially recognizes the market valuation, gives the banks much more flexibility in terms of how they can manage their portfolio of loans, and may be seen as a necessary component in the banks' overall strategy for handling their developing country exposure.

(f) Changing tax and regulatory environment

In principle, changes in the tax treatment of provisioning and/or the regulatory environment might be expected to exert an impact on the extent to which banks set aside provisions. However, in practice, it is difficult to discern a marked impact. The tax positions seem frequently to be rather unclear and ill-defined, and, whereas regulators have generally supported the idea of more provisioning with growing enthusiasm, the extent of regulation has often been no more than to encourage the banks to review their general approach to the subject. Certainly those involved in the provisioning exercise do not ascribe any significant role to tax and regulatory factors in explaining inter-temporal changes in the extent to which it has occurred. It may, however, and as noted in Section 1, be a more important factor in endeavoring to explain the differing behavior of banks in different countries. Furthermore, to argue that it has not been an important factor in the past is not to argue that it might not be an important factor in the future. It is difficult to believe that a more interventionist approach by regulators or a clearer and more cohesive statement of the tax treatment of provisioning would be completely inconsequential, though its significance might still be marginal in relation to other factors.

The conclusion from the above discussion of secular factors is that there were indeed certain trends in effect during the mid-1980s which pointed in the direction of greater provisioning. Of these perhaps the most important were the changing assessment of the economic performance of debtor countries and a desire by the banks to do something positive in terms of their own balance sheets. But these secular trends hardly explain why the surge of provisioning in the summer of 1987 occurred when it did, nor do they explain entirely satisfactorily why different banks behaved in different ways. It is to an examination of more proximate and bank-specific factors that we now turn.

Micro Factors

(a) Market valuation

While banks may set out to maximize profits, and while their behavior may be most nearly approximated by applying thi.. traditional theory of the firm, it is also the case that they are concerned about their market valuation as reflected by their share price. In relation to this, they are sensitive to the rating they receive from bank analysts.

Prior to the wave of extra provisioning begun by Citibank in early summer 1987, banks were under significant market pressure to acknowledge the weakness of many of their developing country loans. This pressure took the form of a share price which was largely discounted in proportion to individual bank's exposure in particular countries, a discount on the secondary market value of developing country debt, and, connected with these phenomena, somewhat gloomy reports on the banking sector in general and the relatively highly exposed banks in particular from market analysts. The market had essentially discounted developing country debt in advance of the banks, and bank provisioning can be seen as, in some sense, a response to and recognition of this judgement.

It is not coincidental, therefore, that as banks provisioned their share price tended to rise (as confirmed by the data in Table 10). Normally, of course, one would expect share price and profitability to be positively related but in this case it seems that the market was welcoming what was seen as a more realistic approach by the banks. The fact that the banks had come formally to accept the risks associated with their developing country loans raised market confidence in the provisioning banks.

Furthermore, it was perhaps, in part, through the market mechanism that actions by key debtor nations affected the banks' provisioning decisions. Although Peru's limitation of debt servicing had relatively little effect on market mood, Brazil's suspension of interest payments did have an effect, and, through this indirect route, if not through more direct routes to be outlined below, Brazil's actions are relevant in seeking to explain why the banks took the decisions that they did at the time that they did.

(b) The competitive process

It needs to be remembered that banks are in competition with one another. Even though there may be elements of market segmentation, this is not sufficiently pronounced to allow banks to have effective areas of monopoly. Within the competitive process banks employ various weapons covering both the range and price of the services they offer to their customers. Banks also compete via marketing and advertising. Given the significance of competition amongst the banks, and since the structure of the banking industry is such in most countries that large banks are able to identify their principal competitors, it might be supposed that any decision made by one bank will take into account its effects on competitor banks, and, in turn, their likely responses.

In this type of market environment firms will be inclined to take actions which they deem to be relatively advantageous. Even an action which damages short-run earnings and profits might become attractive if it forces competitors to take similar actions which have effects on their earnings and profits which are even more damaging. In such an environment the initiating firm will strengthen its relative position within the industry. Since provisioning affects earnings, profits, and share prices, it seems likely therefore that the implications of it for a bank's competitive position within the industry will feature in the decision.

How important a factor this is depends on how wide the differences are between banks in terms of their ability to set aside provisions and how aggressively competitive are the banks in the relatively stronger positions. In a highly competitive environment, a decision by one bank to raise its provisions might even be viewed as a predatory policy, akin to the practice of predatory pricing in other industries. 17/

(c) The politics of decision making

The discussion in points (a) and (b) above suggests that financial and economic factors are the only ones that have an effect on bank decisions. It needs to be recalled, however, that banks are bureaucratic structures and decisions will reflect managerial utility functions. Changing managerial regimes within any firm may cause a shift in policy. An incoming Chairman may, for example, wish to distance himself (or herself) from decisions taken by a predecessor and to impose a new personality and authority. An outgoing Chairman may wish to secure the company's position before departing in order to minimize the personal risk of being retrospectively blamed for ill-founded decisions.

17. Some commentators have certainly identified a new era of the entrepreneurial spirit of competition. Similarly, and somewhat more graphically, the Chairman of Citibank has been described by a fellow banker as the "Rambo of the money center banks."

While it is difficult to model these factors and to treat them in a rigorous way, those with experience of working in large organizations recognize that personalities and internal organizational politics are often important factors in decision making. It might be unwise, therefore, to ignore such influences when trying to explain commercial bank provisioning.

(d) The games theory of debtor-creditor relations

Provisioning by the banks has not been an isolated action, but represents one component in an ongoing set of negotiations and relationships between debtor countries and creditor banks. While the debtors wish to minimize their servicing obligations without damaging their prospects of future market access, the banks wish to maximize their receipts. Such maximization may involve agreeing to terms which are not so stringent as to encourage debtors to opt for all out default. Within such a set of negotiations the participants will be constantly "positioning" and trying to send "signals" to each other designed to strengthen their own bargaining stance. It may be anticipated that participants will sometimes adopt positions which are more conciliatory and at other times less conciliatory. Similarly the adoption of a new position by one side will tend to induce a change in the position adopted by the other side.

Within this context, a decision by banks to increase their provisioning against claims on developing countries might be interpreted as a desire to send a new signal to debtors in advance of forthcoming negotiations. Such action could be initiated by the banks or could represent a response to a perceived change of position by a particular debtor or group of debtors.

However, there is considerable ambiguity about what signal is being transmitted by increased provisioning. From one point of view it may be seen as a softening in the bank's position since, in effect, it reflects a recognition by the banks that they are unlikely to receive full payment on their developing country loans. The whole rationale of provisioning is associated with such increased risks. From this angle, the signal might be seen as one which says that the banks, having provisioned, are now in a better position, and more willing, to make concessions to the debtors.

Bankers vigorously deny that this is the signal that they are sending via provisioning. Indeed, they tend to down play the entire game-theoretic approach to provisioning. If anything, however, they argue that provisioning suggests that the banks will adopt a "tougher" or "more realistic" position vis-a-vis borrowers in rescheduling negotiations. The logic here seems to involve two elements. First, the banks are now in a better position to "take a hit" on their developing country loans. And second, since provisions are now being set aside against such developing country loans, it is going to be more difficult for debtor countries to attract new money from the banks.

Consideration of these elements suggests that while there is some truth in the second (which is examined more fully later in the section of the report dealing with the implication of provisioning), the first argument is more doubtful. The demonstration by the banks that they are in a stronger position to withstand a "hit" may actually make it <u>more</u> likely that they will have to sustain one. Statements by bankers that provisioning does not represent a softer position by the banks and may, what is more, represent a harder one would seem to be designed merely to limit the damage that might otherwise be done to their bargaining position. Chances of the banks being fully repaid would not seem to be enhanced by actions which suggest that the banks accept that they are unlikely to be fully repaid.

Given the ambiguity over the way in which debtors might be expected to interpret bank provisioning, it is difficult to believe that the increase in provisioning during mid-1987 was purely a positioning response to the Brazilian decision to suspend interest payments in early 1987.

Of course banks will not only be concerned about how their decisions will be interpreted by the debtor countries. They also have to consider their relationships with the official sector. Here, in an environment where the banks feel that excessive pressure has been put on them to provide new money in recent negotiations -- in particular those involving Mexico -- and see themselves as often assuming the role of lender of last resort, they might have been pleased to send a message, via provisioning, that new money would be less easily available in the future, and thereby put more pressure on the official sector. Especially since the banks have been quite critical of certain elements of the official sector, notably the Paris Club, the export guarantee agencies, and, lately, the International Monetary Fund (IMF).

Although the above discussion has tended to lump all the banks together, it is quite possible that there are slight, but still significant, differences between banks in the signals they wish to send individual debtor countries. A bank with a relatively large exposure in a particular country may be inclined to adopt a rather different approach than a bank with a smaller exposure.

(e) Bank exposure, profitability and internal bank strategy

As suggested earlier, some banks will be in a stronger position to provision than others. Broadly speaking, the more profitable is the bank and the greater its ability to foster and develop other lines of business, the more inclined it will be to set aside relatively large provisions. Indeed, it will be the banks with the smallest exposure in developing countries that will be inclined to set aside the largest proportionate provisions against these loans because the absolute size of the provisions will be small in relation to those of other banks that are more heavily exposed. 18/

In addition to this, however, some banks may be in a stronger position to exploit the opportunity for debt-equity swaps, which, as will be seen later, is facilitated by provisioning. A bank with a relatively wide network of branches and with good information about investment opportunities in developing countries may be more enthusiastic about the scope for such swaps and may therefore be more anxious to prepare the ground for them. A bank with a less sanguine attitude to swaps may be expected to be less anxious to engage in provisioning.

(f) Tax and regulatory environment

As was noted earlier in the report, perhaps the most noticeable characteristic amongst differences between International banks in their approaches to provisioning is their national identity. To some extent this is explained by the factors already listed. German banks, for example, with

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18. This is confirmed by the data given in Section I.

relatively little exposure in developing countries might be expected to hold larger reserves against their loans than US banks. However, national variations also suggest that differences in national regulations and tax laws may also exert some impact. This is difficult to assess in a thorough way because in many cases, and as noted in Section I, the regulatory environment rests as much on unrecorded understandings as on formal sets of arrangements. What is more, the tax treatment of provisioning also remains far from clear in many countries. Although banks may be able to offset incurred losses or write downs against tax, provisioning does not necessarily imply a formal write down. To circumvent such distinctions Japanese banks, in a much reported move, sold a proportion of their developing country loans at a discount to an offshore company which they jointly owned. 19/

Again, as discovered in Section I, perhaps the most liberal tax legislation exists in Germany where following a "care ul evaluation" of the value of their assets, banks may correct an over-valuation of these assets and may deduct any resulting loss from taxable profits. It is not surprising to find therefore that German banks have historically provisioned heavily. While this may reflect the traditional conservatism of German bankers, tax legislation is also likely to have been an important factor.

Before leaving the question of the tax and regulatory environment, it may be noted that while this may have an effect on provisioning, provisioning may itself have an effect on the tax and regulatory environment. Provisioning may, for example, be made by the banks in the hope of putting pressure on the

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19. Reports are that Japanese banks sold $500 million of Mexican debt at a 42 percent discount to a Cayman Island company owned by 28 of them.

tax authorities to make tax concessions. Similarly greater provisioning may be used by the banks in an attempt to forestall the introduction of formal regulations which would mandate reserves against specific countries.

Assigning Relative Importance: Case Studies

What we have done so far is to assemble a list of factors which might, in principle, have an influence on commercial bank provisioning against developing country loans. What now needs to be done is to assign some relative importance to these factors. In attempt to do this we focus here on the spate of additional commercial bank provisioning that was observed during mid-1987.

First of all, drawing on the distinction between secular and micro factors, it seems that secular factors were necessary but not sufficient for provisioning to occur. Stated most extremely, if there had not been a deterioration in the economic and debt positions of the highly indebted countries, there would have been little need for banks to provision. Yet this gradual deterioration does not seem to have been the proximate cause of provisioning.

Taking the case of the extra loan loss reserves made by the US money center banks, much of this may be seen as a response to the lead set by Citibank. Provisioning by the other banks was in defense of their market position. Most representatives of such banks suggest that extra provisions would not have been set aside had it not been for the Citibank move. The question then becomes why Citibank decided to increase its provisions. Some guidance is provided by Citibank's own account which emphasizes the importance of market pressures, and the desire to create more flexibility within its balance sheet and to pursue debt equity swaps. However, it is reasonable to presume that Citibank would not necessarily provide a full analysis of its own decision. The general consensus amongst competitors and commentators is that there were other important factors. First, there was the desire to gain a competitive advantage over other US money center banks. The Citibank announcement was carefully orchestrated and well marketed, and it did undoubtedly embarrass some of the other banks. Although Citibank was heavily exposed in developing countries in absolute terms at end 1986 and had more exposure than the other money center banks, it s exposure to equity ratio was significally below that of Bank of America and Manufacturers Hanover, was broadly similar to that of Chase Manhattan and Chemical Bank, was somewhat above that of Bankers Trust and signifcantly above that of the other smaller U.S. Citibank was therefore not in a uniformity stronger position to set aside provisions, but was in a rather stronger position than its closest competition, particularly given its attitude towards debt equity swaps. Second, there was the personality of the Citibank chairman, which some observers feel suggests that internal bank politics may have been a factor.

Perhaps rather less important was the desire to send a coded message to debtors, and to Brazil in particular, since, as mentioned above, the precise message is difficult to decode. Also apparently of no importance was the tax position, in spite of the fact that early press reports suggested that tax advantages lay at the heart of the decision.

Similarly, the regulatory environment seems to have been of little relevance, except to the extent that some observers feel that Citibank was anxious to forestall moves to change the regulations in a way which would require greater specific provisioning.

Broadly the same story emerges when one examines the additional provisioning undertaken by the UK clearing banks. Here again the process was led by the bank regarded as perhaps the most aggressively competitive, the National Westminster Bank. Moreover, National Westminster, with relatively low loan exposures in developing countries, was in the strongest position to provision against such loans. As with the Citibank move, Nat. West's additional provisioning strengthened its market position and this induced the other cleaning banks to take similar measures. Again in the UK, the regulatory environment and the tax position with respect to provisioning does not seem to have had a significant impact. Although UK banks had been encouraged by bank regulators -- essentially the Bank of England -- to review the adequacy of their provisions, the tax treatment of provisioning was undefined at the time the National Westminster took its decision. Discussions with representatives of National Westminster also suggest that game-theoretic explanations did not have an important part to play. Instead the feeling was that Citibank's move had altered the "market environment" and that it was therefore an appropriate time for the bank to bring greater realism into its accounts. In the case of Nat. West there seems to have been a less well-articulated internal bank strategy for handling its exposure than there was in the case of Citibank.

This review of the causes of provisioning suggests that it reflects a combination of general secular trends and narrower, more bank specific, factors. Without doubt the overall performance of debtor countries in the mid-1980s and beyond was providing little evidence that their ability to service debt was going to improve in the short run. The financial markets certainly made this assessment, which was reinforced by greater difficulties in rescheduling and by unilateral decisions by key debtors to limit their debt payments. As a result the market valuation of the banks' loans to developing countries was discounted. Provisioning represented a response to this deteriorating situation. However, within the banking industry, provisioning has also been used in a competitive way; there was no uniformly agreed approach to it, but rather one of action and counter action. Although banks have been anxious to ensure that their negotiating position is not damaged by provisioning, it is doubtful whether the prime rationale was to send a positioning signal to debtors. Similarly, while different regulatory and tax environments may help to explain why banks in different countries have provisioned to different extents, changes in this environment do not seem to have exerted any discernible impact on provisioning over time.

Having examined what factors caused banks to provision more heavily, we can now move on in the next section to examine the implications of such decisions.

III. IMPLICATIONS OF PROVISIONING

According to one point of view the implications of increased provisioning are likely to be rather marginal, since it is essential an accounting adjustment which acknowledges and formalizes a weakness in banks' balance sheets which existed beforehand. Although there would appear to be some truth in this view, it is possible to examine the potential implications of provisioning in a rather more thorough and systematic way.

In this section we approach the question by looking at the implications for the various actors involved in the International debt problem; the banks, the debtor countries and the official sector. We also briefly examine the implications of provisioning for relations between these various actors.

(a) For the banks

As already noted, provisioning has the effect of bringing the banks' actual balance sheets more in line with the market perception of what they should look like. Any discrepancy of this kind between the market view and the banks' view, as illustrated by their published balance sheets, will be a cause of concern within the market and will damage confidence in the banks. Removal of this discrepancy will tend to restore a measure of confidence. It might have been anticipated, as bankers themselves clearly did, that provisioning would improve the banks' market position. Data given in Table 10 confirm the positive short-run effect of provisioning on banks' stock prices. The Table also suggests, when read in conjunction with Table 5 showing the dates of provisioning, that it was the earlier provisioners that enjoyed the greatest stock price increase.

However, it is perhaps more doubtful how durable this improvement will be. After all, provisioning does nothing to strengthen the basic position of those banks which have suspect developing country loans on their books. Neither, as will be seen below, does it really do anything to raise the probability that debtors will be able to service their debt obligations.

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The expectation might therefore be that provisioning would have a short-run beneficial effect on banks' share prices, but that in the longer term the relative market valuation of the banks would not increase. For this to occur the banks would need to shed some of their developing country loans and expand profitable new lines of business. Alternatively, the economic performance and prospects of the debtors would need to improve significantly.

Clearly banks with less exposure in developing countries will tend to have a stronger market position than those with a heavy concentration of loans, although even non-exposed banks may find it difficult to distance themselves completely from the market's judgement of the heavily exposed one, not least because banks' fortunes may, to an extent, be inter-related through the inter-bank market.

The anxiety to shed developing country debt will, with little doubt, encourage banks to consider the scope for debt sales, and for debt equity swaps. Either one of these will be encouraged by provisioning which marginalizes the banks' decision to accept a discounted price for developing country debt.

In the past the quantity of debt swaps has been constrained, in part, by the unwillingness of the US banks to accept a reduction in the face value of their developing country assets. Although increasing loan loss reserves is not the same thing as writing down debt, it does suggest a presumption that some debt will need to be written down. For this reason one constraint on debt conversion will be relaxed by provisioning.

How significant this relaxation is depends on how effective the constraint is. Some observers have argued that debt swap activity is more effectively constrained by the range of suitable equity investments in highly indebted countries and by the attitudes of the debtor country governments to foreign investment. If these are indeed the effective constraints, then provisioning is unlikely to have significant implications for the level of debt swapping.

Even amongst bankers there are significantly different views on just how important debt swapping will be, though all agree that provisioning has the important effect of making their loan portfolios more flexible or "malleable." Some bankers see debt equity swaps as a key integral part of their internal strategy. Citibank, for example, made press announcements to this effect when reporting its additional loan loss reserves. Others see the potential for debt swaps as being small in relation to the size of the debt involved. While there is, then, some debate over the precise size of the impact of provisioning on debt swap activity, there is little disagreement over the point that, with other things remaining constant, provisioning will encourage banks to engage in more debt swapping than would otherwise have been the case. [20]

There is similarly little disagreement that provisioning will make banks more unwilling to put new money into developing countries. The logic here is simply that if a bank has provisioned against old loans it will also

20. For a more detailed analysis of debt swapping see, Graham Bird, "Debt Swapping in Developing Countries: A Preliminary Investigation," Journal of Development Studies, (forthcoming).

need to provision against new ones. Provisioning is, in effect, a tax on new developing country loans and may therefore be expected to reduce the supply of such loans.

But provisioning may reduce the supply of new bank loans in other ways as well. First, small banks may become even more reluctant to participate in new money packages since they see the larger banks as being in a stronger financial position. The argument that the involvement of the small banks is required to sustain the larger banks, and therefore, the stability of financial markets, may be more easily rejected than it has been formerly. Second, inasmuch as provisioning has been used, or has been perceived as having been used, by some banks as an aggressive weapon of competition, it may be more difficult to get the necessary degree of agreement amongst banks to put together new money packages.

More generally, it might be expected that banks with relatively large provisions will be more inclined to favor some form of debt relief to developing countries in preference to the injection of new money. Indeed, the extent of provisioning has been used in the past to explain the different attitudes of US and German banks to the debt problem, with the former holding relatively low loan loss reserves and favoring new money as opposed to any form of debt relief. The gloomy prospect from the debtors' point of view is that, while extra provisioning may disincline the US money center banks and other International banks from making available new money, it may not include them towards greater debt relief. Indeed in their public pronouncements bankers are adamant that additional provisioning does not imply that the banks are prepared to accept anything less than the full servicing and repayment obligations associated with the developing country loans. They frequently maintain that provisioning is a response to market perceptions of effective default risk rather than a reflection of their own perceptions.

Of course care has to be exercised in interpreting such statements. Bankers anxious to maximize the chance of being fully repaid are unlikely to make statements to the effect that they do not expect this to be what happens. They will be aware of the fact that such prophecies would stand a good chance of becoming self-fulfilling, with debtor countries immediately adopting a tougher stance in debt negotiations.

Many bankers in fact accept that a degree of debt forgiveness may be appropriate for some of the smaller debtor countries which they concede may be in intractable economic difficulties. But, at the same time, they are worried that it would be difficult, in practice, to offer significantly different terms to different debtor countries, and that the large debtor nations would expect to receive terms similar to the most favored debtor.

A more detached viewing of the facts suggests that it may have been anticipated that bankers would say exactly what they have been saying. But it is difficult to reconcile actions which prepare the banks for some measure of loss on their loans with words which say that such losses are not expected. On the assumption that actions generally speak louder than words, it seems reasonable to conclude that the banks have accepted that they will be forced to grant a measure of debt forgiveness. The choice of words is designed to try and minimize the banks' losses.

While clearly the choice of technique adopted by the banks for giving de facto debt relief is aimed at minimizing the amount of such relief, an interesting and related question is whether this technique is optimal from the debtors' point of view, or indeed systemically. Does the banks chosen route maximize the real relief for any given financial cost? Or, in other words, does it represent an efficient way of handling the international debt problem? In principle, an alternative might be for the banks to opt for a structured, co-ordinated and centrally administered write down of loans, to be attached to policy conditionality applied to the debtor nations.

Banks may be forced by circumstances to concede to some degree of relief. Indeed the scenario painted by many bankers is consistent with this conclusion, even though it may not be the conclusion they themselves draw. First, there is the deteriorating performance of the highly indebted countries. Second, there is the gloomy global macroeconomic outlook. Third, there is the fact that, in general, significant quantities of new monies cannot be expected from the banks. If neither private foreign investment nor the official sector fills the projected financing gap, the only option left open for debtor countries is to reduce their demand for foreign exchange through the imposition of direct import limiting measures or through domestic demand deflation; unless, that is, the debtors decide to reduce their demand for foreign exchange by defaulting on their debt obligations.

Banks need to recognize and address the issue that, while formalized debt relief does possess the problem of "moral hazard" touched on above, failure to provide it may induce outright defaults which will make their losses even greater. This, of course, is the trump card that debtors possess in their game-theoretic negotiations with the banks.

However, while, for these reasons, provisioning might be seen as a potential step towards some greater measure of debt relief, the way in which it has been enacted may have damaged the cohesiveness of the banks and therefore have made co-ordinated approaches more difficult to implement. As noted above, some US money center banks feel that Citibank's decisions to add to its loan loss reserves was, in part at least, a predatory move designed to embarrass them and to give Citibank a competitive advantage. This could change attitudes towards what has been the co-operative fashion in which debt negotiations have been handled by the banks, and this at a time when the growing reluctance of the small banks' to participate in new loans is likely to place a larger burden on the large money center banks. Indeed one of the most frequently cited criticisms of Citibank's move from the rest of the banking community is precisely that it has disrupted what was formerly co-operative approach by the banks, and that it will make the negotiation of new packages more problematical.

This argument should not, however, be taken too far. Banks are always likely to take decisions based on what they see as being in their own best interests; and although greater provisioning may influence this perception, decisions within any set of debt negotiations are unlikely to be motivated simply out of desire to make life difficult for one particular competitor. While the discussions amongst the banks may therefore be somewhat less fraternal than they might have been, outcomes will be similar to those that would have resulted had the decisions to add to loan loss reserves been collaboratively agreed.

Again in trying to gauge the relative importance of the factors discussed above, bankers clearly feel that the most significant implication of provisioning for them is the extra flexibility it gives in the management of their balance sheets. Increased loan loss reserves provide them with the scope to pursue a number of options which would otherwise have been effectively unavailable. Apart from this, and in and of itself, provisioning is not seen by bankers as having hugely significant implications for them.

(b) For the indebted countries

The consequences of provisioning for the highly indebted borrowing countries are generally regarded as being even less significant than for the banks. As pointed out by country representatives on many occasions, provisioning does nothing to alter their contractual debt-related obligations.

Even so, there are, in principle, channels through which extra commercial bank provisioning might have consequences for the debtor countries. First, it may alter the negotiating environment; altering the relative strengths of the debtors' and creditors' bargaining positions. Although, as already seen, the banks argue strongly that provisioning is a sign of their hardening or "more realistic" attitude towards certain borrowing countries, it is difficult to reconcile this with the changing expectations of debt servicing that provisioning implies. Of course just as the banks would not be expected to publicize a softening in their attitudes if indeed this exists, the borrowing countries would not be expected necessarily to reveal their true interpretation of the effect of provisioning on their bargaining strength. Press stories therefore not surprisingly present the debtor countries' response to provisioning as having been fairly neutral, although some suggestions have been made that, since the banks have essentially written down the value of their developing country loans, developing countries should only be required to pay interest on the reduced real value of the debt.

Second, as already explained, provisioning does reduce the likely size of new money flows from the banks to the highly indebted countries. If these flows are not replaced from other sources, and if there is no related relief in debt obligations, provisioning will have increased the size of <u>ex ante</u> negative net transfers. The sign and size of net transfers is an important ingredient in models of debt repudiation, with larger negative net transfers increasing the incentive to default. If, indeed, highly indebted countries did now perceive the benefits of default as exceeding the costs, and acted accordingly, provisioning, which was designed to regularize banks' balance sheets to the existing debt situation, could in principle make that situation worse. Extra provisioning, far from being the one-off action which some bankers present it as, could possess its own internal dynamics. A worsening debt situation brought about by provisioning could itself result in additional provisioning and a further deterioration in the debt situation.

The third way in which extra commercial bank provisioning might affect the debtor countries is through its impact on debt swap activity. This is not the place to provide a detailed analysis of the potential effects of debt equity swaps on the "host" country. [21] Clearly, however, such swaps reduce the external debt obligations of the debtor country and may induce additional equity investment. If such benefits outweigh the potential costs associated with exchange rate and monetary management, and the result is therefore that debtor countries derive net benefits from debt equity swaps, then, anything that encourages swapping will be of advantage to the debtor

21. See Bird <u>ibid</u> for a discussion and analysis of this.

country. As discussed above, extra provisioning does help to weaken one of the former constraints on debt equity swaps.

Provisioning would be of greater relevance to debtor countries if it could be legitimately interpreted as part of a trend towards greater debt forgiveness by the banks. However, as yet there is no strong reason for feeling that such a trend exists. In these circumstances its adverse effects on new money flows could easily mean that debtor countries lose out.

(c) For the official sector

Just as a reduced flow of new money from the banks has implications for the debtor countries, it also has implications for the official sector. In essence, it increases the pressures on the World Bank and the IMF to play a larger role both in financing balance-of-payments deficits, and in articulating appropriate adjustment strategies through the conditionality that both institutions can bring in to bear on debtor nations.

More generally, if provisioning makes the debt problem worse by increasing the incentive for debtors to default, it increases the systemic need for compensating action to be taken. Since provisioning may be seen as a step by the commercial banks towards extricating themselves from the investment in developing countries -- certainly in the form in which it has taken place over recent years -- it leaves more of a vacuum to be filled by the multilateral agencies. 22/

This is certainly a reasonable reflection of views within the banking

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22. For a discussion of how the banks view their own future contribution to financing economic development see, Restoring Market Access: New Directions in Bank Lending, Institute of International Finance, Washington, June 1987. The emphasis is placed on projects and on backing the domestic private sector.

community. the unanimous feeling is that the offi . l sector, fairly widely defined, should be doing more to help resolve the debt problem, not only in making financial concessions and in refurbishing conditionality, but also in terms of orchestrating and taking an overall lead in the approach to international debt. An important implication of greater provisioning is that this expanded role becomes more likely.

More specifically, and perhaps in the shorter term, debtor countries facing greater difficulties in refinancing their loans from the private sector may find it progressively more awkward to meet their outstanding obligations to the multilateral agencies and these will therefore not be entirely exempt from the default concerns of the private sector.

While the banks are certainly not in a position to opt out of the debt problem, there may be a case for shifting the balance of significance more towards the official sector. To the extent that provisioning assists such a shift it could be of systemic advantage.

Within the official sector provisioning by commercial banks will force the regulatory and tax authorities to define their own attitudes more clearly. This may result in tensions within the sector. Regulators anxious to sustain the security and stability of the financial system may be expected to welcome additional provisioning. The tax authorities, on the other hand, may not be anxious to make the tax concessions that might help to encourage provisioning. Moreover, the wing of the official sector dealing more directly with financial flows to the developing world may be worried about the effects of provisioning on total flows.

In all the above discussion it would be a mistake to isolate commercial bank provisioning as being of the greatest strategic importance. Many of its implications are marginal and are frequently somewhat uncertain.

Indeed some commentators have argued that one of the central implications of provisioning is precisely the additional uncertainty it generates. In terms of the principal issues involved in the resolution of the international debt problem provisioning is probably of rather limited significance. Perhaps its greater significance would be if it reflected an attitudinal change on behalf of the banks. But it is difficult to be certain about the extent to which this has taken place.

The next section of the report therefore moves on to examine broader issues relating to International debt and to see where provisioning fits into such issues.

IV. PROVISIONING AND DEBT STRATEGIES FOR THE FUTURE

There is no shortage of opinion as to wherein lies the best chance of solving the international debt problem. At one end of the spectrum is the line of argument that market measures should be assigned the principal role. This sees the future as involving the expansion of secondary markets and of debt equity swaps. To the extent that there might be official intervention this would focus on capping interest rates. The optimists point out that debtor countries can simultaneously taken on more debt and improve their debt situation provided they achieve adequate rates of economic growth. Again the argument is that the best chance of securing such growth is to deregulate domestic markets and to allow the private sector to assume greater significance. 23/

At the other end of the spectrum are those who are more pessimistic about the future and are certainly skeptical as to whether the debt problem may be resolved by relying so heavily on the unimpaired workings of the market. Such skepticism spawns the view that the official sector should have an expanded role and that new devices and initiatives from this sector will be required if the debt problem is to be overcome in an efficient fashion. Opinions, however, vary about the details of the devices and initiatives that are required. 24/

In the context of this report there is little point in undertaking a full review of the various schemes that have been put forward in the literature. Instead the approach adopted here is to investigate how provisioning might fit into and facilitate alternative global debt strategies.

In one important respect provisioning by the banks may be seen as fitting neatly into the market-related solution since, as pointed out earlier, it facilitates debt conversion. However, a common criticism of debt equity swaps is that they do not generate any significant additional resources, but merely re-channel investment that would have occurred anyway. If this is the case, debt equity swaps emerge as being a better tool for dealing with one part of the debt problem, the overhang of debt, than with another part, the generation of future loans.

Some bankers deny that there will be a strong demand for new loans,

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23. For a concise presentation of this point of view see Martin Feldstein, "Muddling Through Can Be Just Fine," The Economist, June 27, 1987.

24. For a review of some of these see Graham Bird, International Financial Policy and Economic Development: A Disaggregated Approach, Macmillan, London, 1987.

or argue that the loans will only be forthcoming if the debtor countries pursue economic policies that are deemed sensible by the financial community and if their economic performance improves. Others argue that, while the market mechanism may help the banks to reduce their debt-related exposure in developing countries, future lending will have to rely on the official sector. Again, as mentioned earlier, there seems little doubt that provisioning will have a negative impact on the availability of new loans from the banks.

Yet bankers themselves remain skeptical of the feasibility of many of the plans designed to enhance the financial role of the official sector, and in particular of those which envisage establishing some form of International Discounting Agency which would buy the banks out of the developing country loans. 25/

More often than not bankers emphasize the importance of a leadership role for the official sector, in particular, the World Bank and IMF. Of late they express some concern over what they perceive as a weakening in Fund conditionality, and a general lack of stewardship by the multilateral agencies. To some bankers "leadership" and "stewardship" do not necessarily involve vast additional amounts of money, but instead involve a clearly thought out strategy, a clear statement of this strategy, and a firm but constructive use of conditionality. At present they see no clear and consistent message coming from the official sector.

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25. Even so, provisioning may provide greater opportunity for converting the developing country debt held by the banks into long-term marketable bonds (or consols) issued either by the countries, with external guarantees, or by an International agency. Conventionally such proposals have floundered on the assumption that banks would not be prepared to take losses on their Third World debt in exchange for less risk in the form of guarantees, but greater provisioning calls this assumption into question.

In this environment it may be worth considering other, apparently less ambitious proposals for setting up some type of international bankruptcy court, called, by one of its proposers, the International Debt Restructuring Agency (IDRA). 26/ This agency might be a joint subsidiary of the World Bank and the IMF and would aim towards providing a setting within which a negotiated resolution of debt service difficulties could be achieved. Debtor countries feeling unable to meet their debt obligations would have the chance to apply to IDRA, which would then bring together all interested parties. Within this framework, creditors might agree to offer the debtor some form of relief. But, in return for this, the debtor would have to accept a degree of policy conditionality to be determined by the IMF and the World Bank. IDRA would then monitor the agreement drawing on the expertise of its subsidiaries, with the hope of seeing the debtor country restored to creditworthiness.

The advantages of this scheme are, first, that it would enable the official sector to provide the leadership that many are calling for. Yet, second, it would not require significant amounts of extra finance which are unlikely to be available. Essentially there would just be the administrative costs of operating the scheme. Third, it would enable both official and private creditors to come together and hopefully agree on an appropriate distribution of debt relief. Fourth, it would enable a cohesive and consistent debt relief and policy conditionality package to be assembled. The official sector would thereby be providing the necessary input in terms of the adjustment incentive. Fifth, and as part of such an adjustment input, the scheme would encourage closer co-operation between the IMF and the World Bank

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26. See Benjamin J. Cohen, "Needed: An International Chapter 11," New York Times, August 18, 1987, p. A23.

in the design of structural adjustment programs. Finally, the inclusion of conditionality, as well as the structured way in which applications for relief would be handled, would help to deal with a "moral hazard" issue, namely that debt relief to one country would result in unmanageable pressures from other countries to receive similar relief.

The proposal has the more general advantage of offering an inducement to both creditors and debtors alike. To creditors, there is the reduced risk of debtor default and the attraction that debtor countries will be encouraged to pursue policies designed to enhance their future ability to pay. To debtors, there is the attraction of receiving relief of their debt obligations, the absence of which might force them to pursue a range of relatively more unpalatable measures. Moreover, both official and private creditors would be brought together to negotiate a common approach. This could help overcome the present position where there are significant problems of perception. The banks feel that first, undue pressure has been put upon them to act as a lender of last resort, second, they have been insufficiently consulted in the design of "rescue packages", and third, many of the resources they have put in have, in effect, been used to bale out the official sector. Meanwhile elements of the official sector feel that the banks have been too reluctant to accept both their part in causing the debt problem and, in relation to this, an adequate share of the adjustment burden.

Of course proposals of the kind outlined above would have very little chance of success if the private banks were unwilling to offer any extended form of relief to debtors. However, in this context, and as noted earlier in this report, the act of provisioning may well imply that the banks are now more prepared to accede to a loss than they were before. They may perceive a new negotiating framework as offering the best chance of minimizing these losses. Moreover, they may be prepared, in effect, to pay something for the greater leadership and refurbished conditionality that they deem appropriate from the official sector.

Although the proposal for a debt restructuring agency primarily focuses on the problem of the debt overhang, it could also have implications for the future flow of funds to developing countries. Not least, the sight of debt difficulties being handled in a more structured and organized fashion could do little other than help the restoration of creditworthiness; something which, as outlined above, would also be helped by the appropriate and effective use of conditionality. Furthermore, the bring together of official agencies and the private banks under the umbrella of such an agency could assist the expansion of co-financing. 27/

If the banks and the official sector did concede to granting additional debt relief under the auspices of a new negotiating framework, a question to be resolved would relate to the form that this relief should take. Fairly clearly its purpose would be to reduce debt-related claims on debtor countries' foreign exchange and the end result would therefore have to lower current debt service payments. Such an objective may be achieved either by reducing payments of principal or of interest. In the past banks have favored the rescheduling of principal and the continuation of interest payments. But given that some banks are encouraging the official sector to provide a mechanism for capping interest rates, they might be prepared to

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27. For a more fully developed analysis of the scope for expanded co-financing see, Graham Bird, Developing Country Borrowing from Private Markets: Key Aspects and Prospects for the Future, Report for the International Finance Division of the World Bank, June 1985.

accept greater rate capitalization themselves. 28/ 29/ Indeed, in one sense, the provision of new money has represented a form of capitalization. With less new money being made available in the future, the banks might be more prepared to redefine the way in which capitalization takes place by attaching it to old loans. 30/

A sensitive problem will remain that of the appropriate distribution of relief between the private and official sectors, and, indeed, within the official sector. Certainly bankers believe that they have frequently demonstrated more flexibility in attempting to alleviate the financing problems of debtor countries than has the Paris Club or to a lesser extent the World Bank and IMF. They will therefore not accept a set of arrangements which they see as offering unilateral relief on their side; hence the need for discussion and negotiation.

Finally, it needs to be recognized that the extent and form of relief may need to vary between debtors. Some of the poorest countries of Africa and Asia may, for example, warrant relief with a higher grant element than that given to Latin American developing countries. At the same time a reasonably clear rationale for such differences needs to be established. Without necessarily believing that a formula has to be rigidly applied, debtors need to be able to identify, a uniformity in treatment according to an established set of criteria. Discussion of these criteria has, however, been defined to

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28. See, for example, the Annual Report of Deutsche Bank, 1986, for the advocacy of an "interest subsidization fund."

29. However, for a critical review of proposals to set up an Interest Rate Compensation Facility within the IMF, see Graham Bird, "Interest Rates and Debt: Would A Cap Fit?" World Development (forthcoming).

30. It is interesting in this context that while some commentators have seen "exit bonds" as a genuine attempt to allow small banks to extricate themselves from lending to the Third World, others see the punitive rates of return on such bonds as effectively encouraging them to stay in.

lie beyond the scope of this report.

Attempts to help resolve the debt problem along the lines outlined above should not be regarded as exclusive, but merely as one component of armory of policies. Banks will no doubt continue to develop new items to include on their "menu of choice". At the same time, proposals for international insurance schemes based on the official sector but privately financed as well as for selective allocations of Special Drawing Rights seem worthy of further consideration. 31/ Similarly, proposals for liberalizing the Compensatory Financing Facility within the IMF, as well as the setting up an equivalent Interest Rate Compensation Facility (IRCF) could make a contribution. 32/ The debt problem is unlikely to be resolved by one particular policy, but rather by a broad strategy which encompasses a number of elements. 33/ The challenge is to ensure that there are enough elements in place and that they are consistent with one another and mutually re-enforcing.

There can be little doubt that, while the banks have a role to play in this strategy, it is not their responsibility to devise and orchestrate it. Given such a supporting role, the significance of commercial bank provisioning to the strategy has to be put in proper perspective. Although not without importance, its importance should not be exaggerated.

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31. See for example, Graham Bird, Developing Country Borrowing from Private Markets ... op cit, and "A Strategy for Global Debt," Millennium: Journal of International Studies (forthcoming).

32. For a discussion of potential reforms to the CFF see Bird, International Financial Policy and Economic Development, op cit, and footnote 28 above.

33. The significance of conditionality should be underlined. Resolution of the global debt problem depends crucially on the pursuit of appropriate policies in the debtor countries themselves.

Table I: EXPOSURE OF MAJOR COUNTRIES' BANKS TO SEPARATE LATIN AMERICAN STATES
End-1986

d-wided bank exposure ibillion		$ million							
		Italy (1) (2)	USA (1)	UK (1)	Japan (2)	Canada (2)	France (2)	Germany (1)	Switzerland (1)
26.6	Argentina	704	9,046	3,677	4,300	1,438	1,900	3,266	1,280
0.7	Bolivia	1	89	94	-	84	100	103	15
77.9	Brazil	439	23,624	9,140	8,200	5,559	8,400	6,328	1,710
13.4	Chile	173	6,254	2,178	1,400	989	600	1,024	545
6.9	Colombia	16	2,155	756	1,000	492	600	507	150
5.0	Ecuador	67	2,017	760	700	288	200	331	85
71.8	Mexico	1,365	23,545	8,669	10,000	5,481	5,500	3,834	1,750
5.5	Peru	70	1,158	649	400	147	700	498	205
2.0	Uruguay	8	889	386	80	84	100	85	95
25.1	Venezuela	496	8,733	2,690	3,650	2,057	2,500	2,107	655
34.9		3,339	77,510	28,999	29,730	16,619	20,600	18,083	6,490

Central Bank statistics.
Estimates by the International Bank Credit Analysis Group (IBCA), London.

Table 2: BANKS RESERVES AGAINST DEVELOPING COUNTRY LOANS, 1986
(in percent and by country)

Belgium	15
Canada	10-15
France	33-45
Germany	35-70 (40)*
Japan	5
Netherlands	24-26
Spain	7-68 (10)*
Sweden	35-80 (50)*
Switzerland	30-60 (40)*
United Kingdom	6-10
United States	5

* Figures in brackets given an approximate average where there is a considerable range of experience amongst banks.

Source: International Bank Credit Analysis Group (IBCA), London.

Table 3: YEAR END-1986 DATA

	DEVELOPING COUNTRY EXPOSURE	ASSETS	LOANS	COMMON EQUITY	TOTAL EQUITY	RESERVES	NON PERFORM LOANS	NET INCOME	COMMON EQUITY ASSETS	TOTAL EQUITY ASSETS	RESERVES/ NPLs	RESERVES/ TOTAL LOANS	DEVELOPING COUNTRY EXPOSURE/ TOTAL EQUITY
									%	%	%	%	%
CITICORP	15,590	196,124	130,904	7,695	9,060	1,698	3,394	1,058	3.92	4.62	50.0	1.30	172
BANKAMERICA CORP	10,000	104,189	73,955	3,329	4,083	2,172	4,031	(518)	3.20	3.88	53.9	2.94	248
MANUFACTURERS HANOVER	8,400	74,397	56,273	3,123	3,766	1,008	2,135	411	4.20	5.06	47.2	1.79	223
CHASE MANHATTAN	8,700	94,766	66,200	4,280	4,882	1,064	1,940	585	4.52	5.15	54.8	1.61	178
J P MORGAN	NA	76,039	34,693	4,880	5,130	910	633	873	6.42	6.75	143.8	2.62	NA
CHEMICAL NEW YORK	5,900	60,564	39,425	2,810	3,120	668	1,349	402	4.64	5.15	49.5	1.69	189
BANKERS TRUST	4,000	56,419	29,201	2,721	2,721	590	879	428	4.82	4.82	67.1	2.02	147
FIRST CHICAGO	2,800	39,147	25,410	2,022	2,347	585	819	276	5.17	6.00	71.4	2.30	119
SECURITY PACIFIC	1,850	62,606	44,343	2,575	2,875	757	1,198	386	4.11	4.59	63.2	1.71	64
WELLS FARGO & CO	1,900	44,577	36,771	1,938	2,343	734	9709	274	4.35	5.26	75.7	2.00	81
FIRST INTERSTATE	1,600	55,421	34,523	2,757	2,759	535	1,021	338	4.97	4.98	52.4	1.55	58

Source: International Bank Credit Analysis Group (IBCA), London.

Table 4: EFFECT OF ADDITIONAL PROVISIONS FOR DEVELOPING COUNTRY DEBT

	Developing Country Exposure	Additional Provision	Second Quarter Earnings	1987 Earnings	----- RESERVES Total	Develop-ing Country	---- Other	Reserves/ Loans %	Reserves/ Developing Country Exposure %	Non-Developing Country Reserves/ NPLs %	Common Equity/ Assets %	Total Equity/ Assets %
CITICORP	15,590	3,000	(2,500)	(1,000)	4,900	3,500	1,400	3.7	22.5	41.2	3.30	4.01
BANK AMERICA CORP.	10,000	1,100	(1,000)	(750)	3,300	1,800	1,500	4.5	18.0	37.2	2.44	3.13
MANUFACTURERS HANOVER	8,400	1,700	(1,400)	(1,050)	2,700	1,850	850	4.8	22.0	39.8	2.74	3.62
CHASE MANHATTAN	8,700	1,600	(1,400)	(850)	2,700	2,000	700	4.1	23.0	36.1	3.45	4.09
J. P. MORGAN *												
CHEMICAL NEW YORK	5,900	1,100	(1,100)	(710)	2,074	1,380	694	4.1	24.8	47.9	3.27	3.79
BANKERS TRUST	4,000	700	(570)	(175)	1,300	1,000	300	4.5	25.0	34.1	4.36	4.36
FIRST CHICAGO	2,800	800	(700)	(435)	1,370	935	435	5.4	33.4	53.1	3.89	4.74
SECURITY PACIFIC	1,850	500	(175)	150	1,300	650	650	2.9	35.1	54.3	4.19	4.68
WELLS FARGO & CO *	1,900											
FIRST INTERSTATE	1,600	750	(455)	(200)	1,200	530	670	3.5	33.1	65.6	4.45	4.46

Note: * Neither of those banks had announced a reserve increase at the time this table was completed, though they did subsequently.

Several of the banks stated that their developing country reserves were 25 percent of developing country exposure, but this was accomplished by adding back the "Allocated Transfer Risk" to reserves. Our table does not add back this reserve and thus the ratios are slightly lower.

Bank America indicated that its reserve was for 25 percent of its $10 billion developing country exposure, but that ratio is achieved only after adding back about $800 million of "Allocated Transfer Risk" reserves and prior charge-offs of developing country loans.

The non-performing loan totals are for year-end 1986 and thus do not include the Brazilian loans placed on nonaccrual status in the first quarter.

The adjusted equity to assets ratios assume that the holding companies pay the same dividends in 1987 as in 1986 and that asset totals at year-end 1987 are the same as at year-end 1986.

Adjustments have been made in the data for Chemical to reflect the acquisition of Texas Commerce in May 1987.

Source: International Bank Credit Analysis Group (IBCA), London.

Table 5: EFFECTS OF INCREASED RESERVES FOR DEVELOPING COUNTRY LOAN EXPOSURES FOR US BANKS

BALANCE SHEET EFFECTS

COMPANY NAME	STOCK SYMBOL	DATE OF RESERVE ADDITION	PRO FORMA RESERVE COVERAGE OF: LDC (a) EXPOSURE	TOTAL (b) LOANS	TOTAL (c) N.P. LOANS	N.P. LOANS (d) 25% LDC EXP.	AVG. EQUITY/AVG. LOANS Q1'87	Q2'87E	% CHANGE	AVG. EQUITY/AVG. ASSETS Q1'87	Q2'87E	%CHANGE	PRIMARY CAPITAL/ASSETS Q1'87	Q2'87	%CHANGE	ESTIMATED % OF PRIMARY CAPITAL COMPRISED BY EQUITY Q1'87	Q2'87E
Citicorp	CCI	19 May 87	25%	3.68%	76.1%	98.9%	7.1	5.2%	-26.6%	4.69%	3.42%	-27.1%	7.0%	7.1%	0.9%	67%	40%
Northwest	NOE	26 May 87	34%	4.01%	98.5%	121.4%	10.2%	9.0%	-12.2%	6.60%	5.01%	11.9%	8.0%	8.9%	1.5%	75%	65%
Chase	CHE	27 May 87	26%	4.05%	58.5%	69.3%	7.5%	5.4%	-28.3%	5.11%	3.67%	28.2%	6.9%	6.9%	0.4%	74%	53%
Security Pacific	SPC	01 Jun 87	36%	2.03%	71.0%	77.0%	10.4%	10.0%	-3.8%	4.64%	4.37%	-5.9%	6.4%	7.4%	15.1%	72%	59%
Rainier	ROAN	02 Jun 87	33%	2.07%	98.1%	83.4%	9.2%	9.0%	-3.1%	6.43%	6.16%	-4.2%	7.3%	7.5%	2.9%	86%	82%
Mercantile Bancorp	MIAC	02 Jun 87	29%	3.19%	83.6%	94.0%	10.4%	9.7%	-7.0%	7.10%	6.61%	-6.9%	8.0%	0.5%	6.0%	89%	70%
Mercanis National	MCNN	02 Jun 87	35%	2.80%	160.3%	159.2%	13.5%	12.8%	-4.5%	7.69%	7.34%	-4.5%	8.5%	8.9%	4.3%	90%	83%
Bank of Boston	BKB	03 Jun 87	36%	3.07%	86.4%	80.4%	7.9%	7.5%	-4.6%	5.73%	5.47%	-4.5%	7.4%	7.9%	7.2%	78%	69%
Bank of America	BAC	08 Jun 87	19%	4.01%	60.2%	63.6%	5.7%	4.2%	-25.6%	4.00%	2.99%	-25.2%	7.3%	7.4%	1.1%	55%	40%
Chemical New York Corp	CHL	11 Jun 87	25%	4.09%	86.8%	75.6%	8.1%	5.9%	-26.9%	5.19%	3.01%	-26.5%	7.3%	7.1%	-2.2%	71%	54%
First Interstate Bancorp	I	11 Jun 87	33%	3.70%	85.5%	86.8%	8.3%	6.9%	-16.9%	5.24%	4.39%	-16.6%	6.9%	7.7%	10.8%	76%	57%
First Chicago	FNB	12 Jun 87	30%	5.52%	105.7%	90.7%	9.5%	6.7%	29.6%	5.73%	3.99%	-30.4%	8.3%	8.2%	0.8%	69%	49%
Shalbrut Corp	SHAS	12 Jun 87	33%	1.96%	122.2%	104.8%	9.0%	9.4%	-4.5	6.51%	6.21%	-4.4%	7.5%	7.4%	-1.3%	87%	84%
NDD Bancorp	NDD	15 Jun 87	30%	1.80%	171.4%	133.2%	10.4%	10.5%	1.2%	5.80%	5.07%	1.1%	6.9%	7.0%	1.5%	84%	84%
Mellon Bank Corp	MEL	15 Jun 87	27%	4.44%	69.4%	71.1%	8.5%	6.2%	-26.4%	5.67%	4.22%	-25.6%	7.2%	7.0%	-3.2%	78%	60%
Manufacturers Hanovers	MHC	16 Jun 87	22%	4.89%	77.4%	71.3%	6.0%	4.3%	-37.1%	4.93%	3.00%	-37.5%	7.3%	7.5%	3.2%	68%	41%
Centerre Bancorp	CTBC	16 Jun 87	35%	2.64%	109.0%	91.4%	11.9%	11.6%	-2.1%	6.30%	6.17%	-2.1%	7.2%	7.5%	3.6%	87%	82%
Bankers Trust N.Y. Corp.	BT	16 Jun 87	25%	4.95%	101.6%	76.6%	10.3%	8.1%	-21.2%	4.75%	3.76%	-20.7%	6.9%	6.9%	0.1%	69%	55%

Source: Keefe, Bruyette and Woods Inc., Banscan, New York.

a) *Total LDC loss reserve allocation as a % of LDC exposure.*
b) Overall reserve as a % of total loans
c) Overall reserve as of % of total non-performing loans (including LDC non-performing loans).
d) Overall reserve as a % of non-performing loans (excluding LDC portion) plus 25% of LDC exposure.

Table 6: EFFECTS OF EXTRA PROVISIONS ON UNITED KINGDOM BANKS
(All in billions @ US$1 = 0.61)

Banks	Developing Country Exposure Incl SA $	Existing Reserves	Extra Prov: Increase to 30%	1986 Pre-tax Profit	Pre-tax Profit after Prov	1986 Equity	1986 Assets	1986 Equity/ Assets	Assuming tax relief of 35%: Extra Prov Net of Tax Relief	Assuming tax relief of 35%: 1986 Equity Net of Net Prov	Assuming tax relief of 35%: 1986 Assets Net of Full Extra Prov $	Assuming tax relief of 35%: Equity Net of Net Prov Assets	Assuming no tax relief: 1986 Equity Net of Full Extra Prov $	Assuming no tax relief: Equity Net of Full Full Extra Prov/Assets
Barclays	3.2 1/	7.0	0.730	0.895	0.165	3.826	76.169	5.02	0.474	3.352	75.439	4.44	3.096	4.10
Lloyds	3.6*	5.0	0.900	0.700	-0.200	2.755	47.829	5.76	0.585	2.170	46.929	4.62	1.855	3.95
Midland	4.3	7.0*	0.982	0.434	-0.548	2.111	53.169	3.97	0.638	1.473	52.187	2.82	1.129	2.16
Nat. West	2.8	13.2	0.463	1.053	0.587	4.702	83.325	5.64	0.303	4.399	82.859	5.31	4.236	5.11
Royal Bank of Scotland	0.2	9.0	0.038	0.185	0.147	0.964	16.597	5.81	0.025	0.939	16.559	5.67	0.926	5.59

Notes: * Estimated
1. Includes South Africa (cross-border), which at end-1986 exchange rates was 728 million.

Rate of provisions: 30 percent
Tax relief rate: 35 percent

Table 7: COMMERCIAL BANKS PROVISIONS AGAINST DEVELOPING COUNTRY LOANS
(Estimated July 1987)

Creditor Country	Reserves (US$ billion)
United States	
15 Largest Banks	26.0
Other Regional Banks	4.0
Japan	
22 Largest Banks	1.5
United Kingdom	5.0
France	10.0
Germany	13.0
Canada	2.0
Switzerland	3.0
Others	6.5
TOTAL	71.0

Source: World Bank (updated).

Table 8: MARKET PRICES OF DEVELOPING COUNTRY DEBT
(selected countries)

	October 1985	October 1986	April 1987	March 1988
Brazil	78	76	64	48
Mexico	80	57	59	49
Argentina	65	66	60	29
Venezuela	82	74	74	54
Chile	69	68	70	58
Peru	33	20	18	7

Source: International Bank Credit Analysis Group (IBCA), London and Salomon Brothers Inc, New York.

Table 9: DEBT INDICATORS FOR AND ECONOMIC PERFORMANCE OF HIGHLY INDEBTED COUNTRIES

	1980	1981	1982	1983	1984	1985	1986
Debt Service Ratio (percent) 1/	18.1	20.0	24.9	24.7	23.1	26.1	29.0
Interest to Exports Ratio (percent)	8.8	10.3	14.3	15.0	15.0	17.1	18.7
Net Transfer (US$ billion)	8.8	18.4	3.8	-7.4	-17.5	-26.1	-24.9
GNP (US$ billion)	858.7	941.0	841.3	726.5	746.3	750.3	776.5
Exports (US$ billion)	163.0	167.1	145.2	138.1	153.7	149.1	132.3
Imports (US$ billion)	196.1	222.8	203.0	157.4	158.4	155.8	150.4

1/ Debt Service relative to exports of goods and services.

Source: World Debt Tables, 1987-88 edition, World Bank 1988.

TABLE 10: MARKET EFFECTS OF BANK PROVISIONING
(June 18, 1987)

		EARNINGS PER SHARE					BOOK VALUE PER SHARE					STOCK PRICE		
	STOCK				% CHANGE		YEAR END			% CHANGE		BEFORE	JUNE	
COMPANY NAME	SYMBOL	1986	1987E	1988E	87E/86	88E/86	1986	1987E	1988E	87E/86	88E/86	ADDITION	1987	%CHANGE
Citicorp	CCI	87.13	(87.25)	812.60	-202%	77%	855.83	845.88	855.78	-17.8%	-0.1%	850.43	862.63	23.70%
Northwest	NOE	3.56	(1.25)	6.00	-135%	69%	38.42	35.37	39.57	-7.9%	3.0%	39.13	44.250	13.10%
Chase	CHE	6.90	(10.30)	10.00	-250%	54%	52.95	40.49	48.35	23.5%	-8.7%	37.25	44.124	18.46%
Security Pacific	SPC	4.86	1.45	5.90	-70%	21%	33.25	32.90	37.00	-1.1%	11.3%	38.30	42.000	9.45%
Rainier	ROAN	3.41	1.75	N.A.	-49%	--	26.85	27.44	N.A.	2.2%	--	47.75%	52.500	9.95%
Mercantile Bancorp	MIAC	3.57	0.15	4.00	-96%	12%	29.50	20.33	30.95	-4.2%	4.6%	24.50	26.750	9.10%
Mercanis National	MCNN	2.45	1.10	3.05	-55%	24%	21.56	21.90	24.35	1.9%	12.9%	26.75	26.750	0.00%
Bank of Boston	BKB	3.49	1.00	4.65	-71%	33%	24.47	24.47	28.12	0.0%	14.9%	34.38	36.750	6.91%
Bank of America	BAC	(3.74)	(6.00)	2.00	60%	N.M.	21.49	15.49	17.49	-27.9%	-18.6%	11.50	11.875	3.26%
Chemical New York Corp	CHL	7.42	(14.03)	9.50	-209%	20%	56.14	39.39	46.17	29.8%	-17.8%	43.80	46.500	5.90%
First Interstate Bancorp	I	7.50	(3.85)	8.75	-151%	17%	58.65	52.00	57.95	-11.3	-1.2%	56.13	59.250	5.57%
First Chicago	FNG	5.00	(8.00)	7.00	-260%	40%	36.91	27.41	32.91	25.7%	-10.8%	30.00	32.000	6.67%
Shelbrut Corp	SHAS	5.07	(3.85)	6.15	-176%	21%	39.56	33.47	37.50	-15.0%	-4.5%	48.50	47.375	-2.32%
MDD Bancorp	MDD	3.65	3.45	4.65	-5%	27%	39.24%	31.49%	34.94	7.7%	19.5%	36.75	56.508	-8.68%
Mellon Bank Corp	MEL	6.20	(10.00)	7.25	-390%	17%	63.68	44.79	50.13	-30.5%	-21.3%	35.13	56.625	4.27%
Manufacturers Hanovers	MNC	8.00	(26.25)	14.00	-390%	59%	74.32	44.79	55.51	-39.7%	-25.3%	44.00	45.000	0.28%
Centerre Bancorp	CTBC	3.90	3.00	5.00	-23%	28%	43.47	44.67	47.87	2.8%	10.1%	37.25	38.000	2.01%
Bankers Trust N.Y. Corp.	BT	6.01	(2.15)	9.00	-136%	-50%	38.78	34.95	42.27	-9.9%	9.0%	54.25	53.750	-0.92%

Source: Keefe, Bruyette and Woods Inc., Banscan, New York.

N.A. Not applicable (Rainer to be acquired by Security Pacific.
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